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C O N F I D E N T I A L SECTION 01 OF 03 BAKU 001399

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DEPARTMENT OF ENERGY PASS TO A/S KAREN HARBERT, DAS ALAN
HEGBURG, OFFICE OF RUSSIA/EURASIAN AFFAIRS DIRECTOR LANA
EKIMOFF

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SUBJECT: AZERBAIJAN AND BP-LED CONSORTIUM MOVE CLOSER TO
RESOLVING DISPUTE

REF: A)BAKU 1224 B) BAKU 1268

Classified By: Ambassador Anne E. Derse, Reasons 1.4 (b,d)

¶1. (C) SUMMARY: In an October 26 meeting with DAS Bryza, BP Azerbaijan head Bill Schrader said that BP planned to propose to the State Oil Company of Azerbaijan (SOCAR) that a working group be formed to help clarify each side's understanding of the other side's position concerning the dispute over how to split 'profit oil' coming from the ACG field. In an October 29 meeting with visiting BP Head of Exploration and Production Andy Inglis, President Aliyev accepted this proposal, and said that resolution of the current dispute between Azerbaijan and the ACG Consortium would be resolved jointly within the parameters of the relevant Production Sharing Agreement and "without embarrassment" to either party. END SUMMARY.

¶2. (C) BACKGROUND: The commercial dispute between the ACG Consortium (formed as a result of the 1994 Azerbaijan Chirag Guneshli (ACG) Production Sharing Agreement, and consisting of BP, Chevron, Inpex, SOCAR, Statoil, ExxonMobil, TPAO, Devon, Itochu and Hess) and the Government of Azerbaijan, as represented by the State Oil Company of Azerbaijan (SOCAR), centers on three main issues, the first two of which influence the percentages of 'profit oil' going to each party:

- Calculation of the "Total Transportation Cost" (TTC)
- Calculation of the "Rate of Return" (ROR)
- SOCAR claim of collusion between the BTC and AIOC Consortiums so that the BTC project was deliberately slowed down in order to influence TTC by driving up transportation costs (Reftels A, B).

¶3. (U) In an October 26 meeting with DAS Bryza and Ambassador Derse, BP Azerbaijan head Bill Schrader explained the current status of negotiations between the ACG Consortium and the GOAJ, as represented by SOCAR.

¶4. (C) Schrader recounted that on October 1 he had been summoned to a meeting at SOCAR with SOCAR President Rovnaq Abdullayev, Advisor Murat Heydarov and SOCAR Vice President Vaqif Aliyev, during which a belligerent Abdullayev said that if BP didn't capitulate to SOCAR demands concerning resolution of the short-term issues in contention, Abdullayev would "let the genie out of the bottle." Explaining, Abdullayev said that SOCAR would unilaterally calculate how much "profit oil" BP and Consortium partners should be

receiving, with any amount over that being received by the Consortium to be considered as "embezzlement." Abdullayev told Schrader that he would have "people out in the streets" protesting against BP, and that Schrader would personally be "charged with embezzlement" and "tried in the Majlis" for "stealing 10 billion dollars" of Azerbaijani money. Schrader said one reason Abdullayev might be pursuing this tack was that threatening to make BP criminally liable could serve as a catalyst for re-negotiations, since BP would not want to list this potential liability, which it would have to list on its annual report to shareholders.

15. (C) However, Schrader said if he acquiesced to SOCAR's demands, then BP could be legally liable to the other Consortium partners. He said that Consortium partner ExxonMobil in particular is famous in the industry for its policy of "never renegotiating," and would "come after" BP if it backed down in this dispute. Although Schrader said he didn't want to go to arbitration, adhering to the process of dispute resolution was key, and that if BP went into arbitration and subsequently lost, "he would be fine with that."

16. (C) He told Bryza and Ambassador that at the October 19 ACG Consortium steering committee meeting, Abdullayev did not claim that the Consortium was in "material breach" of the PSA, which would have triggered a process that could have led to arbitration. Rather, he railed against BP for 90 minutes, accusing it of fraud and conflict of interest, and giving it one week to solve all outstanding issues.

17. (C) Subsequently, on October 23 Abdullayev sent Schrader a letter saying that the Consortium had one week to go back to

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the former method of calculating Rate of Return (ROR). Schrader explained that the difference between the two methodologies could mean as much as four billion dollars additional income to either party.

18. (C) As to why SOCAR was complaining about a BP change in calculating ROR, Schrader explained that at the end of 2006 SOCAR inquired as to the method of calculating the ROR, causing the Consortium to commission Deloitte & Touche to "go through the PSA" and compare it with ongoing Consortium practices. Among the subsequent recommendations made by Deloitte was to include "deemed finance charges," accrued by each company as part of its cost of capital, as part of petroleum recovery costs. When a second subsequent opinion by Freshfields Bruckhaus Deringer confirmed this recommendation, the ACG Consortium's Contract Management Committee (CMC) approved this change in calculating ROR, which resulted in more profit oil coming to the Consortium in order to defray these expenses.

19. (C) Schrader told Bryza that on that day (October 26) he had just finished drafting a letter to SOCAR President Abdullayev in response to Abdullayev's October 19 demand that BP "settle all outstanding issues" within a week. Against the advice of BP's own lawyers, Schrader decided to "do a data dump" on SOCAR, and attached to this letter four reports from external firms validating the Consortium methods used for ROR calculation. Schrader said in his letter to Abdullayev he proposed forming a "working group" to discuss the key issue of ROR calculation. This group wasn't for negotiation; rather, it would be to "share understandings of the PSA" and to "clarify positions." Schrader said such a group was key because although SOCAR keeps leveling general accusations against the Consortium, it has "refused to engage" and discuss the specifics under contention.

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10. (C) On October 30 BP Azerbaijan President Bill Schrader met with Embassy Energy Officer to provide a readout of the

October 29 meeting between President Aliyev and BP Head of Exploration and Production Andy Inglis.

¶11. (C) According to Schrader, Inglis and Schrader met with President Aliyev on October 29, with other GOAJ participants being SOCAR President Rovnag Abdullayev and President's Counselor on Economic Affairs Ali Asadov. BP also brought Edward Whitehead, a BP executive who had been intimately involved with the drafting of the ACG PSA (note: Schrader said BP flew Whitehead from San Juan, where he is retired but on BP retainer, primarily to show the GOAJ that BP has the 'institutional memory' re the PSA).

¶12. (C) The meeting started with both sides agreeing on the good progress that has occurred in joint endeavors since August, to include progress on the fourth Shah Deniz well. Both sides also commented favorably on the high price of oil. Launching into the meeting's substance, Aliyev said that the GOAJ always has and will always adhere to the contracts it has signed, and that it is not Azerbaijan who is the "bad guy" in the dispute between the ACG Consortium and the GOAJ - BP is the one who has "changed the contract." Inglis pushed back, saying that BP believes that it has adhered scrupulously to the PSA and that everything it has done is consistent with the PSA. Inglis told Aliyev that it has sought to discuss the issues involved many times with SOCAR, but Inglis branded SOCAR as "unresponsive" to BP's repeated attempts to engage. Inglis told Aliyev that BP President Schrader had just submitted to the President's office a letter with various outside legal and auditing opinions attached, all of which showed that the accounting methodologies that BP was using to calculate Rate of Return (ROR) were consistent with the PSA.

¶13. (C) Inglis mentioned to Aliyev the suggestion that a working group be formed to look at the finance issue, i.e. the issue of how the ROR is calculated, with the group to present its findings within one month. In addition to BP and SOCAR, this working group would have representatives from the Finance Ministry, the State Oil Fund (SOFAZ) and the

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President's Office. Aliyev agreed, saying that his goal was to solve the ROR issue "before the year's end." As for the rest of the issues, both short-term (to include transit tariff costs- TTC) and longer-term (PSA extension and access to ACG Deep Gas) Aliyev said he was in favor of seeking to solve them "as a package."

¶14. (C) In a brief post-meeting one-on-one discussion between Aliyev and Inglis, Inglis told Aliyev that SOCAR President Abdullayev's threats to "try Schrader as a thief" and to "let the genie out of the bottle" in terms of harassing BP could be a source of real embarrassment to GOAJ, asking him "is that really what you want?" In response, Aliyev said that whenever there were disputes in the past, both sides have worked them out within the context of the PSA, without embarrassment, and that this time will be no different. While Aliyev and Inglis were talking, Schrader said that SOCAR President Abdullayev told him that the PSA annexes (in which the methodologies relating to ROR calculation were stipulated) did not have the same legal force as the PSA itself). An incredulous Schrader said that legally speaking there was no difference between the PSA itself and the annexes.

¶15. (C) Schrader told EnergyOff that he planned to meet with SOCAR President Abdullayev on October 31 to further discuss this working group. At that time, he said he planned to tell Abdullayev that he did not appreciate his 90 minute diatribe against BP during the recent ACG Steering Committee meeting, laden as it was with unjustified and irresponsible charges. SOCAR was not adequately representing the interests of the GOAJ in its interactions with the Consortium and as such henceforth on all important correspondence, in addition to making submissions to SOCAR, Schrader would cc the Finance

Ministry, SOFAZ, and Ali Asadov at the Presidential Apparat.

¶16. (C) Schrader said that Inglis has been key to resolving the issue, due to the strong relationship between Inglis and President Aliyev that has existed for more than a decade, dating back to Aliyev's time at SOCAR. Schrader says that it is unlikely that he himself can replicate the strong relationship that Inglis has with the President, or the one that existed between the President and his own predecessor, Sir David Woodward. Schrader said that he himself would not seek to strengthen his relationship with Aliyev, since Aliyev has made it clear that he prefers Schrader to deal with his Economic Advisor Ali Asadov. Rather, he will use Inglis "as needed."

¶17. (C) COMMENT: It seems that tensions continue to de-escalate between the GOAJ and BP, and BP is at least now more convinced that President Aliyev has a fuller picture of the status quo than when it was receiving information solely from SOCAR. BP's decision to involve Presidential aide Ali Asadov more fully is a wise one, as the President trusts Asadov's advice. Once the ROR issue is solved, the road will at least be more clear for resolution of the longer-term issues of PSA extension and access to ACG Deep Gas. END COMMENT

¶18. (U) DAS Bryza has cleared this cable.
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